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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

No. 361

BURTON-SUTTON OIL COMPANY, INCORPORATED,
Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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INDEX

Subject Index.

	Page
Argument	1

Table of Authorities Cited

Anderson v. Helvering, 310 U. S. 404	3
Kirby Petroleum Co. v. Commissioner, No. 56, October, 1945 Term	3
Haynes v. U. S., 50 Fed. Supp. 238	3
Helvering v. Elbe Oil Land Co., 303 U. S. 372	4
Helvering v. O'Donnell, 303 U. S. 370	3
Murphy, William R., v. Commissioner, 6 T. C. No. 42, February 28, 1946	4
Palmer v. Bender, 287 U. S. 551	3
Procter and Gamble Manufacturing Company, The, v. Commissioner, T. C. Memorandum, February 18, 1946	4

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The issue here is focused on the Commissioner's present contention that "* * * an interest in net profits to liquidate a cash payment [made without regard to production] which is depletable as a bonus when the recipient has continuing rights to share in production by way of an oil royalty, but is not depletable by the recipient or excludable by the payer when it is not associated with a royalty interest" (Br. 24) and the taxpayer's primary position that "an economic interest is no less than an oil royalty when the right is to share a net profit."

The Commissioner's argument in his *Kirby* brief (p. 21) was:

> "We submit that it is altogether untenable to hold that an interest in the operator's net profits may or may not represent a depletable interest, depending upon whether the right to receive royalties has been retained. A royalty, representing the right to share in the production of the oil, clearly gives rise to gross income from the sale of oil and is depletable. But how that interest becomes enlarged to include a more extensive one in the production of oil merely because there is an additional right to share in net profits, or how a share of net profits represents a share of the production of oil only when there is another different right to a portion of production through oil royalties, is exceedingly difficult to comprehend."

Footnote 6 in the *Kirby* decision was in apparent agreement because it stated:

> "While the reservation of royalties shows an economic interest in the oil necessary for the satisfaction of the royalties, such reservation would not show an economic interest in oil not necessary for the payment of the royalties. But see *Japhet* v. *Commissioner of Internal Revenue*, 3 T. Ct. (F.) 86."

The Commissioner's brief in *Kirby* (p. 21) further stated:

> "We submit that there is no reason why a share in the operator's net earnings should give rise to a depletable interest in the oil produced; but if such reason does exist, the net profits should not be chameleonic, their character changing with the other interests which the assignor or lessor may possess."

and by way of footnote illustrated the capricious results which would obtain from the establishment of the rule for

which the Commissioner now contends in the present case.

Again, we believe the *Kirby* decision accepted the Commissioner's argument because it was stated:

> "If we assume that the only payment for the privilege of oil extraction made to the taxpayer lessees by the lessees was the portion of 'net income' fixed under the leases, it would be clear that such payment of 'net income' would taxwise be rent or royalty paid by the lessees for the privilege of extraction."

The *Kirby* opinion certainly means more than that net profit payments are like cash payments which do not depend upon production. The basis for the decision, in our opinion, is that

> "The lessors economic interest is no less [than a gross royalty] when the right is to share a net profit."

Therefore, Gulf having the right to net profit payments, whether it became a technical sublessor or not, retained an economic interest identical with that of a lessor. Cf. *Palmer v. Bender*, 287 U. S. 551, 558.

To our discussion of the *O'Donnell* case (page 15 of brief) we wish to add that the Court's view of this case in the *Kirby* decision seemed to be "since O'Donnell was an entire stranger to the lease, the payments cannot in any view be regarded as rent." (Commissioner's brief, page 44, *O'Donnell* case, No. 436 October, 1937 Term.) The same result applies even if the consideration is measured by gross production. *Haines v. U. S.* (Court of Claims), 50 F. Supp. 238.

The grounds upon which we distinguish the *Ellis* case (brief pages 17-20) are not "infirm", as the Commissioner now contends (Br. 26) but are the very same reasons he urged to this Court in obtaining the judgment. The Com-

missioner's brief in the *Elbe* case (docket No. 446 October 1937 Term), stated:

> "*Pro tanto* the transaction constitutes a purchase of an economic and legal interest in the oil in place and this regardless of the nature of the parties relationship once Honolulu has reimbursed itself and the provisions of paragraph 8 [net profit payment after contingencies] became operative" (p. 20).
>
> "In the view of the case which has been taken the nature of the interest acquired by Elbe under the provisions of paragraph 8 is of no consequence" (p. 23).

It is not at all necessary to determine here whether a cash payment not dependent upon production is depletable. The issue here, unlike the *Elbe* case, is whether actual receipts dependent upon production are depletable.

The Tax Court interprets the *Kirby* case as requiring an allowance for depletion where the net profit payment is the *sole* interest in production. *The Proctor and Gamble Manufacturing Company* v. *Commissioner*, Docket No. 3338, February 18, 1946 (C. C. H. Tax Court Decisions, p. 23257) allowance to a landowner-lessor; and *William B. Murphy, et al.* v. *Commissioner*, 6 T. C. No. 42, February 28, 1946 (C. C. H. Tax Court Decisions, p. 23264) allowance to former owner of lease. The *Murphy* case cannot be distinguished from Gulf's position here.

The Commissioner now urges that adoption of a rule that net profit payments are depletable only when the recipient has a gross royalty "has the obvious advantage of avoiding undue administrative complexity" (Br. 24). (Compare, however, his *Kirby* brief pages 21 and 22.) In our view the statue may be administered just as easily under the Tax Court's interpretation of the *Kirby* decision.

We respectfully submit that there must be regard for the "practical consequences of the provision for payments" (*Anderson* v. *Helvering*, 310 U. S. 403, 411). Unless the door is to be opened for "sales" of income producing properties of all sorts for shares of net profits, whereunder the "vendor" is to enjoy, at the same time, both the economic advantage of income from the property and taxation at capital gains rates, decisions must have regard for realities. In order to maintain his position here the Commissioner would have a rule established under which Gulf has "sold" its capital investment.[1] If that is true, Gulf is entitled to first recover its entire capital investment and then have its remaining receipts accorded preferential treatment as capital gains. Thus, Gulf, after a tax-free recovery of its capital investment, would have its tax limited to twenty-five (25) per cent on its remaining receipts. Why should Gulf enjoy a tax rate of 25% on 50% of the income while the taxpayer here is also chargeable with 100% and can be required to pay rates as high as 80%?

Gulf's sole purpose was to obtain income from the operation of the wells, it has such income, and we think that it should, like the taxpayer, bear taxes upon the income as such. Indeed, periodic (monthly) payments which must be made (1) as long as the payer continues to use the property

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[1] While the decision here must, of necessity, determine whether Gulf "sold" its capital investment in the oil, the Commissioner (Br. 16, 25) and the taxpayer (Br. 8, 12, 18) agree that this question should be decided by the practical character of the provision for payment and not by the kind of legal relationship of the parties nor how the instrument itself might be classified, without regard to the practical consequences of the provisions for payments, as an "assignment" or "sublease." If, however, the Court should disagree with this principle, the Commissioner (Br. 13) contends that the instrument is essentially an outright assignment while the taxpayer's view (Br. 12, 13, 24) is that the transaction was essentially a sublease.

and (2) as a condition of the contract granting the use, partake of the quality of rent and require corresponding tax consequences.

Respectfully submitted,

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